STATEMENT OF RICHARD M. RICCOBONO, DEPUTY DIRECTOR
OFFICE OF THRIFT SUPERVISION
ON
ALLOWANCES FOR LOAN AND LEASE LOSSES
BEFORE THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
OF THE
COMMITTEE ON BANKING AND FINANCIAL SERVICES
OF THE
UNITED STATES HOUSE OF REPRESENTATIVES

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Introduction

Good Morning Chairwoman Roukema, Ranking Member Vento, and members of the Subcommittee. Thank you for the opportunity to present the views of the Office of Thrift Supervision (OTS) on allowances for loan losses (allowances), as well as our work on this issue with the Securities and Exchange Commission (SEC) and accounting organizations, such as the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA). I will address some of the questions in your letter of invitation in the body of my testimony. I am also including an attachment with specific responses to all of your questions.

The Office of Thrift Supervision (OTS) believes it is very important that savings associations have allowances that are sufficient to cover losses inherent in their loan portfolios. In making and retaining loans, savings associations, as well as other financial institutions, manage significant amounts of credit risk. Loans have traditionally been the source of most of their credit risk and losses. Financial institutions, their independent accountants and their regulators face serious challenges in determining what level of allowances are necessary to cover loan losses.

Estimating allowances is by nature subjective, and requires a high degree of management judgment. The establishment of adequate allowances is critical to the safe and sound operation of financial institutions since they must be able to absorb loan losses to remain viable. If losses exceed allowances and income, capital, which even in well capitalized associations is generally not much more than 10 percent of assets, begins to erode. When the protection of allowances and capital is not sufficient, the federal deposit insurance funds are forced to absorb the losses to cover insured deposits.

The appropriate allowance level will fall within an acceptable range of estimated losses. Generally accepted accounting principles (GAAP) require financial institutions to estimate their allowances within the range of probable credit losses, including estimates at the high end of that range when that is the best estimate. As the primary regulator of savings associations, OTS requires savings associations to maintain a level of allowances and capital that will cover inherent losses and allow them to withstand adverse events. We encourage savings associations to increase allowances based on safety and soundness concerns when those allowances do not otherwise adequately reflect all probable losses inherent in the loan portfolio. We are committed to ensuring that savings associations maintain conservative, prudent, and robust allowances.

Before focusing more on the specific issue at hand, I believe it is important to address some key questions. First, what is an allowance for loan losses, what level of allowances does a savings association need, and how does OTS determine if allowances are appropriate? Next, I will outline what we see as the current issue, and whether there is a case for conservative allowances. I will also explain how we are working together with the SEC, and summarize recently issued accounting guidance. Finally, I will outline what I see as the next steps.

What is an allowance for loan losses?

The term “allowance” (valuation allowance) is an accounting term. Allowances are a mechanism for financial institutions to recognize the difference between the recorded loan amount and the amount they are likely to collect. GAAP requires financial institutions to recognize loan losses under one of two different methods. Using one method, financial institutions evaluate each loan individually to determine if collection in full is probable under Statement of Financial Accounting Standards (SFAS) No. 114. Using the second method, financial institutions evaluate groups of loans with similar risk characteristics to determine whether collection in full is probable under SFAS No. 5.

An example may help illustrate the point. Assume a lender has a $100 million loan portfolio, composed of 1,000 loans, with no identified “problem” loans. Based on past experience, the lender estimates that one percent of those loans will be charged off within the next year because of inherent, but unidentified, losses in the portfolio today. If the lender knew today which of the 1,000 loans were uncollectible, then the lender would charge those loans off today. Since the lender has not yet identified which loans are uncollectible, it is prudent to maintain an allowance of $1 million ($100 million x 1 percent) to reflect those inherent losses under SFAS No. 5. This results in a net loan balance of $99 million ($100 million - $1 million). As the lender identifies individual loans in the portfolio as uncollectible over the next year, it will charge them off against the allowance.

As a matter of policy and law, OTS requires all savings associations to follow GAAP when preparing their financial statements and quarterly reports submitted to OTS. We require the savings associations we regulate to apply GAAP by reference to authoritative accounting pronouncements and predominant industry practice. With respect to the development of authoritative pronouncements by the FASB and the AICPA, OTS frequently provides comments on drafts of new accounting guidance that could have a significant impact on the thrift industry.

What level of allowances does a savings association need?

Managing the level of allowances is an integral part of a savings association's credit risk management process. Savings associations should maintain prudent, conservative, but not excessive, loan loss allowances that fall within an acceptable range of estimated losses. To determine the right amount of allowances, savings associations and examiners consider the association's historical loss experience. They also consider the association's portfolio composition, its level of classified assets, the quality of its underwriting, the adequacy of collateral, environmental conditions, and current economic trends. Even further, the savings association and examiners consider the experience of the association's lending staff, its internal lending policies and procedures and the adequacy of its loan collections.

To establish an adequate allowance, an association must be able to recognize when loans have become a problem. An effective loan review system and internal controls that identify, monitor, and manage asset quality problems in an accurate and timely manner are essential. These systems and controls must be responsive to changes in internal and external factors that affect the level of credit risk and ensure the timely charge-off of loans, or portions of loans, when a loss is confirmed.

How does OTS determine if allowances are appropriate?

OTS examiners review the adequacy of a savings association's allowances during each on-site examination, which is every 12 to 18 months, depending on the association's size and CAMELS rating. This includes an assessment of management's methodology for determining the adequacy of the allowance. OTS staff generally monitor allowance levels between examinations using quarterly Thrift Financial Reports, reports obtained from management, and the Uniform Thrift Performance Report. More frequent on-site examinations may be conducted if the monitoring process identifies concerns with the savings association's practices. Despite the benefits of ongoing monitoring, OTS strongly believes that on-site examinations are essential to determine the adequacy of the allowance.

The primary guidance used by OTS examiners and savings association management is the "Interagency Policy Statement on the Allowance for Loan and Lease Losses" issued in 1993 (Interagency Statement). We include this document as guidance to examiners and the industry in our Thrift Activities Regulatory Handbook. The Interagency Statement discusses the nature and purpose of the allowance, the responsibilities of an institution's board of directors and management, factors to consider in estimating credit losses and examiner responsibilities. It also includes quantitative guidance that financial institutions and examiners can use to check the reasonableness of an institution's allowance methodology.

The Interagency Statement refers to GAAP guidance (SFAS No. 5 and No. 114), and uses concepts derived from SFAS No. 5. It also states that an allowance established in accordance with the Interagency Statement will fall within the range of acceptable estimates developed in accordance with GAAP. The language in the Interagency Statement reflects comments by the staffs of the FASB and the SEC received throughout the policy development process.

What is the current issue?

In a statement issued on March 10, 1999, we agreed to work jointly with the SEC, FASB, and AICPA over the next two years to provide additional guidance and to revisit the appropriateness of allowance practices in light of developments in portfolio credit risk measurement practices. We are concerned, however, that recent messages sent to the industry may have created some confusion. In particular, we are concerned that savings associations may interpret these communications as requiring fundamental changes to their allowance policies, resulting in an unwarranted reduction of allowances.

Much of the current discussion about the adequacy of reserves has centered on whether they are too high. In fact, thrift allowances have declined from a high of 0.84 percent of total assets in 1993 to 0.63 percent in March 1999. Charge-offs and additions to allowances have declined because of the robust economy, and we feel this overall decline in allowances in acceptable. Nevertheless, we should be clear that associations have not been bulking up their allowances.

In evaluating whether savings associations have excessive levels of allowances, it is important to remember that historical charge-offs are a lagging indicator that may bear little relationship to losses inherent in the portfolio today. Evaluating the adequacy of allowances is a complex judgment that cannot be reduced to a formula based solely on historical charge-offs without consideration of various other factors.

Savings associations are, in general, setting their allowances at appropriate levels. Some institutions may find It prudent to maintain their allowance levels at the highest end of the acceptable range of estimated losses. This practice is consistent with GAAP where that estimate represents the best estimate. Regardless of the level of allowances, however, some associations may need to improve the documentation of their allowance methodology. Further, others may need to expand disclosures in their financial statements.

Is there a case for conservative allowances?

As some savings associations move into new, higher-risk lending activities, heavy reliance on historical charge-off levels to set allowance levels may be especially inappropriate. Examples of such higher-risk lending activities include subprime consumer lending and high loan-to-value mortgage lending. Recent charge-offs in these non-traditional lending areas have been substantially higher than for more traditional higher quality loans.

When a savings association enters a new line of business, it has no historical experience to use to project future charge-offs. Under these circumstances, it is very difficult to estimate losses and determine the adequacy of allowances. When an association misjudges the risks of a new line of business, significant losses may occur.

To illustrate, in 1996, just in time for seasonal holiday shopping, a savings association decided to enter the private label credit card services business and to specialize in jewelry loans. To recognize the inherent losses in this higher-risk specialized lending activity, the association increased its allowances by 60 percent to $7.2 million. As it turned out, this increase in allowances was wholly inadequate. Within nine months, the association lost $27.2 million, or 3.8 times the amount of the allowances.

With the benefit of hindsight, it is easy to criticize the decision to enter this particular line of business. More importantly, we believe that this association's decision to increase its allowances by 60 percent before identifying which specific loans had inherent losses was a prudent initial step, even though it ultimately proved insufficient. It is a step that we would encourage every lender that initiates a new, higher-risk lending program to take. We do not want to discourage savings associations from significantly increasing their allowances when they enter new, higher-risk lines of business.

How are we working with the SEC?

Based on our experience with cases like the one I noted, we felt it was crucial to work closely with the other banking agencies, the FASB and the SEC to provide additional guidance to the banking industry. To that end, we issued a joint interagency statement on allowances in November 1998. That statement outlined certain concepts to provide a foundation for further joint projects. Since January, the federal banking agencies have entered into frequent discussions with the SEC on allowance policy issues. This has included meetings among the chief accountants and other senior policy representatives of the SEC and the banking agencies. These discussions have helped the SEC and the banking agencies to achieve a better understanding of how to address these issues.

Our discussions also led the SEC and the federal banking agencies to issue a joint interagency letter to financial institutions on March 10, 1999. In that letter, we announced additional measures designed to address the uncertainty among financial institutions about the expectations of the banking and securities regulators on the appropriate amount, disclosure, and documentation of allowances. Those additional measures included the establishment of a joint working group, including policy representatives from the SEC and each of the banking agencies, to gain a better understanding of the procedures and processes, including “sound practices," used commonly by financial institutions to determine allowances for credit losses.

We also announced that, using information gathered through the joint working group and from representatives from the public accounting profession and the banking industry, we would work together to issue parallel guidance, on a timely basis. The target date for the SEC and banking agencies to issue guidance on appropriate methodologies, disclosures, and supporting documentation is March 2000.

Since issuance of the March 10 press release, we have had many discussions (including phone calls and face-to-face meetings) between staff at various levels within the SEC and the federal banking agencies. We have established joint working groups and developed project development plans that include specific project completion time lines. At the OTS, we have devoted, and we expect to continue to devote, a significant amount of our resources to this effort.

Thus far, the SEC and the banking agencies agree on the following fundamental principles:

- Arriving at an appropriate allowance involves imprecision; therefore, requires a high degree of management judgment and results in a range of estimated losses;

- Prudent, conservative, but not excessive allowances that fall within an acceptable range of estimated losses are appropriate. In accordance with GAAP, an institution should record its best estimate within the range of credit losses, including when management’s best estimate is at the high end of the range;

- An “unallocated” allowance is appropriate if it reflects an estimate of probable losses, determined in accordance with GAAP, and is properly supported;

- Allowance estimates should be based on a comprehensive, well-documented, and consistently applied analysis of the loan portfolio; and

- The allowance should take into consideration all available information existing as of the financial statement date, including environmental factors such as industry, geographical, economic, and political factors.

What accounting guidance has been recently issued?

In the March 10 press release, we also announced that we would work together to encourage and support both the FASB’s and AICPA’s process of providing additional guidance. With that goal in mind, the federal banking agencies jointly issued comment letters to the FASB on March 26. Specifically, we commented on the guidance that the FASB was developing with respect to allowances and the interaction between SFAS Nos. 5 and 114. On April 12, 1999, the FASB issued its guidance, “Application of FASB Statements 5 and 114 to a Loan Portfolio,” in a *Viewpoints* article.

At a meeting of the FASB’s Emerging Issues Task Force in May, SEC staff announced that compliance with the guidance in the *Viewpoints* article could result in a change in the application of GAAP, and noted the need for a transition adjustment, if material. SEC staff stated that any such adjustment should be reported and disclosed by SEC registrants as a separate component of net income in the second quarter of 1999 ending June 30.

Immediately following the SEC staff announcement, the OTS, OCC, and the FDIC sent joint letters to representatives of the House and Senate Banking Committees. These letters discussed our concern that recent actions could result in a decrease in the level of allowances for loan losses by financial institutions.

What are the next steps?

We do not expect many savings associations to make significant adjustments to their allowances based on the messages they have received to date. However, we are concerned that some confusion may still exist. We recommend that the issues raised in connection with allowances continue to be resolved through cooperative efforts among the banking agencies, the SEC, the industry, the AICPA, and the FASB, as set forth in our March 10 interagency letter.

Given the fundamental changes that have taken place in accounting interpretation and credit-risk management techniques in recent years, a broader re-examination of accounting standards for allowances appears beneficial. In this regard, current accounting practices may not reflect advances in risk management techniques and technology, such as the use of credit scoring and modeling techniques that may more accurately forecast prospective losses. An approach that looks beyond historical data is needed.

While we fully concur that allowances must not be used to manipulate reported earnings, we believe it would be unfortunate to not recognize these changes. Of more importance, it would be extremely unfortunate if financial institutions were to inappropriately decrease their allowances based on confusing signals. As we've previously noted in letters to Congress, such a result could have a negative effect on the continued safety and soundness of America's banking system. In our judgment, this would not be in the best interests of the federal deposit insurance funds or financial institution shareholders.

We encourage continued cooperation to send a unified message. Financial institutions must maintain a prudent and reasonable allowance, and a methodology that is well documented, appropriately disclosed in financial reports, and generally consistent from one reporting period to the next. We look forward to working closely with the other banking agencies, the SEC and the accounting organizations to provide guidance to financial institutions in this regard. Our expectation is that joint cooperative efforts will address this issue. We thank you for your interest.

RESPONSES TO QUESTIONS RAISED IN THE JUNE 8, 1999 INVITATION LETTER

1. Federal law requires that financial statements to be filed by banks with the federal bank agencies must be in compliance with GAAP. Some have suggested that in the area of loan loss reserves the Federal banking agencies apply regulatory accounting principles ("RAP") to banks and thrifts which are less stringent than GAAP. Please discuss what accounting standards the Federal banking agencies apply to financial institutions, and if it is GAAP, the process by which the Federal banking agencies interpret and apply GAAP.

OTS requires the savings associations it regulates to follow generally accepted accounting principles (GAAP) in preparing their financial statements and quarterly reports to OTS. OTS does not require savings associations to apply accounting standards that are contrary to GAAP. We expect savings associations to apply GAAP by reference to authoritative accounting pronouncements and predominant industry practice. Moreover, when addressing complex accounting issues, OTS encourages savings associations to consult with their independent public accountants.

The primary guidance used by OTS examiners and savings association management is the “Interagency Policy Statement on the Allowance for Loan and Lease Losses,” issued in 1993 (Interagency Statement). This document is included as an appendix to Section 261 of the Thrift Activities Regulatory Handbook, “Adequacy of Valuation Allowances.” The Interagency Statement discusses the nature and purpose of the allowance, the responsibilities of a financial institution’s board of directors and management, factors to consider in estimating credit losses, and examiner responsibilities. It also includes quantitative guidance that can be used by examiners to check the reasonableness of a financial institution’s allowance methodology.

The Interagency Statement refers to GAAP guidance, (SFAS No. 5 and No. 114), and uses concepts derived from SFAS No. 5. It states that an allowance established in accordance with the Interagency Statement will fall within the range of acceptable estimates developed in accordance with GAAP. The language in the Interagency Statement reflects comments received from the staffs of the FASB and the SEC as it was being developed. We intended for the Interagency Statement to provide more specific guidance than what was provided in SFAS Nos. 5 and 114.

2. Please discuss how frequently examiners review a financial institution's loan loss reserves. Please describe the guidance to examiners regarding review and evaluation of such reserves. Does this guidance require examiners to review allowances to determine if they are in accordance with GAAP? In reviewing loan loss reserves do the Federal banking agencies compare loan loss reserves to financial institutions in the same peer group as well as local and regional economic trends?

As noted in response to question number one, examiners use the Interagency Statement to review allowances. OTS examiners review the adequacy of a savings association's allowance during each on-site examination, which is every 12 to 18 months, depending on the association's size and CAMELS rating. Among other things, examiners assess management's methodology for determining the adequacy of the allowance. OTS staff monitor allowance levels between examinations using quarterly Thrift Financial Reports, financial data obtained from management, and the Uniform Thrift Performance Report. OTS also performs peer group comparisons of similar financial institutions' allowance levels. Such comparisons are not always helpful, however, because many similar sized financial institutions may have substantially different asset and liabilities, underwriting standards or risk management practices.

3. Some have suggested that the Federal Banking agencies <u>always encourage</u> institutions to increase their reserves, whether warranted or not due to safety and soundness concerns. Please discuss whether this is consistent with existing examiner guidance.

There is no OTS guidance, written or otherwise, that instructs examiners to always encourage savings associations to increase allowances, whether warranted or not, based upon safety and soundness concerns. OTS written guidance stresses that adequate allowances should be established and maintained, given the savings association's historical loss experience and other factors. Determining the adequate level of a saving association's allowances is imprecise, dependent on many factors and requires considerable judgment. When assessing the many variables, examiners, auditors and savings association managers may come to different conclusions as to the adequacy of a particular level of allowance. Ultimately reaching the right number often requires negotiations between the association's representatives (including its independent auditor) and OTS examiners. Differences that fall outside the acceptable range permitted by GAAP will result in an adjustment.

4. Please discuss whether the SEC has consulted with and coordinated its comments on loan loss reserves with the Federal Reserve and other federal banking regulators. Please discuss whether you believe consultation between the SEC and the federal banking regulators prior to the SEC issuing loan loss reserve comments would be workable and whether prior consultation would promote a more consistent approach to GAAP.

The SEC does not consult with or coordinate its comments on allowances with the OTS. For those institutions that file statements with both the SEC and the OTS, we are usually able to obtain the SEC's comments directly from the savings association. Based on our review of filings, we initiate communications with the SEC on unique, novel, or material items, including allowances that have the potential for adjustment. We do not coordinate with the SEC on savings associations that file public reports solely with the SEC.

We do believe that it would be beneficial, and workable, for the SEC and OTS to consult prior to the issuance of comments on allowances or other material items. Such a process would ensure that the savings association, the OTS and the SEC have sufficient knowledge surrounding an issue to make an informed decision consistent with GAAP. A coordinated process would also ensure that the savings association receives a consistent message from both securities and banking regulators.

On a broader level, the OTS and the SEC meet several times a year to discuss various policy issues dealing with accounting and disclosures. The discussions are based on more expansive policy issues as opposed to specific discussions on an individual savings association basis.

5. Please discuss whether you believe there is a widespread problem with financial institutions inflating their loan loss reserves outside of what is permitted under GAAP.

Savings associations are, in general, setting their allowances at appropriate levels. Some savings associations, in order to maintain prudent and conservative allowances, select an estimate at the highest end of the acceptable range of estimated losses. That practice is consistent with GAAP where that estimate represents the best estimate.

The annual financial statements of nearly all OTS-regulated institutions are audited by an independent public accountant. We are not aware of <u>any</u> situations where the independent public accountant has taken a GAAP exception due to excess allowances.

6. In the early 1990s several financial holding companies were sued for securities fraud with respect to arguably inadequate loan loss reserves. Did you take action against any of the savings associations or holding companies involved?

We do not capture the information you requested as specific to securities fraud. OTS has, however, taken many enforcement actions to address inadequate allowance levels. OTS has formal and informal enforcement tools to carry out its supervisory and enforcement responsibilities. Although these tools range from informal actions, such as supervisory directives, to formal actions, such as cease-and-desist orders, we generally are able to resolve our differences regarding the adequacy of allowances through informal means during the examination process.

7. In response to the problems of the early 1990s, did the SEC meet and work with the Federal banking agencies on loan loss reserves?

a. **Did the SEC review or have input into the 1993 Interagency statement on loan loss reserves? Please comment generally on how bank loan loss reserve practices have changed since 1993.**
b. **Please describe how the SEC and Federal banking agencies communicated and coordinated on the loan loss reserve and other accounting issues between 1993 and November of 1998.**

c. **In November of 1998 and March of 1999 the agencies issued interagency statements on the loan loss reserve issue. Please discuss these statements and how the coordination provided for in these statements is working.**

a. The Interagency Statement was reviewed by SEC's Chief Accountant and his staff. Prior to the issuance of the Interagency Statement, many savings associations established allowances based on what they believed was an acceptable percentage of assets; others used sophisticated computer modeling analysis, such as migration (or roll-rate) analysis that used their historical loss experience to determine allowance levels. The Interagency Policy Statement stressed the importance of GAAP and that allowances should be based on historical loss experience, adjusted for current conditions and trends. As a result of the flexibility allowed by the Interagency Statement, and because of generally lower charge-offs since 1993, many savings associations have been able to reduce allowance levels as a percentage of total assets. Current practices for setting allowances may also reflect fundamental changes that have taken place in credit-risk management techniques such as the use of sophisticated analytical tools for stress testing, concentration and correlation analysis, or similar modeling devices.

b. There was very little communication and coordination between the SEC and the federal banking agencies on allowance policy issues between 1993 and November 1998. Apparently, allowances had not been a significant policy issue for the SEC during that period. However, there were ongoing communications on various other accounting policy issues during that period.

c. On November 24, 1998, the federal banking agencies and the SEC issued a joint press release, in which we announced that we had agreed to work together with the public accounting profession and banking industry in developing further guidance with respect to allowances. In that press release, we stated that we recognize the importance of financial institutions having prudent, conservative, but not excessive allowances.

On March 10, 1999, the federal banking agencies and the SEC again issued a joint press release. This time, we announced additional measures designed to address the continued uncertainty among financial institutions as to the expectations of the banking and securities regulators on the appropriate amount, disclosure, and documentation of allowances. Those additional measures included the establishment of a joint working group, including policy representatives from each of the federal banking agencies and the SEC, to gain a better understanding of the procedures and processes, including "sound practices," used commonly by financial institutions to determine allowances for credit losses.

In that press release, we announced that, using information gathered through the joint working group and from representatives from the public accounting profession and the banking industry, we would work together to issue parallel guidance, on a timely basis. (Later, we also decided to seek information from the legal profession.) This guidance, to be issued by March 2000, would include discussions on appropriate methodologies, supporting documentation, and enhanced disclosures. We also announced that we would work together to encourage and support both the FASB's and the AICPA's process of providing additional guidance.

Since issuance of the March 10 press release, in connection with our commitment to issue guidance in this area, we have had many discussions between staff at various levels within the SEC and the federal banking agencies. We have established joint working groups and developed project development plans that include specific project completion time lines. At the OTS, we have devoted, and we expect to continue to devote, a significant amount of our resources to this effort.

8. The FASB issued Statement No. 114 in 1993. This Statement was supposed to supplement FASB Statement No. 5. Did the SEC, Federal banking agencies and FASB work on Statement No. 114 together?

The federal banking agencies and the SEC did not work closely together with the FASB on the development of SFAS No. 114. However, each of the federal banking agencies and the SEC separately provided a significant amount of input to the FASB during the development of that statement.

9. Please discuss your understanding of the issues which the AICPA Task Force on Loan Loss Reserves is intended to address.

According to its draft prospectus, the primary objective of the AICPA Allowance for Loan Losses Task Force is to provide a Statement of Position (SOP), that will provide additional GAAP guidance on periodic loan loss provisions and the related loan loss allowance. In addition, the Task Force may provide supplemental recommendations on credit risk management techniques and documentation matters, including best practices. To accomplish its objectives, the Task Force intends to review and examine existing GAAP, while identifying aspects that may need clarification. Preliminary plans call for the issuance of a final SOP in the second quarter of 2001.

10. The Federal banking agencies closely monitor economic trends on a regional, national and international basis. Please discuss whether you believe that financial institutions should be permitted to establish loan loss reserves for expected future losses based on local or regional market conditions or expected trends.

Recording an allowance for expected future losses is generally considered inconsistent with GAAP. Under GAAP, allowances are established and maintained only for losses inherent in the portfolio, not for future losses or losses based on the risk that a loan may default in the future. Some believe, however, that allowances should be sufficient to cover expected future losses. The time frame over which allowances should be based is under much debate and we hope will be satisfactorily addressed by the FASB and the AICPA.

11. In connection with the Viewpoints article the SEC indicated that transition adjustments for loan loss reserves should be made prior to the end of the 2nd quarter. Please discuss whether you expect many financial institutions to take advantage of this one time opportunity.

As a result of the *Viewpoints* article and the SEC transition statement, financial institutions may change their practice of determining allowances. This could result in a reduction of allowances. We cannot determine, however, which savings associations, if any, will make an adjustment. We will review the second quarter financial data for such adjustments, and continue to actively monitor the industry for significant changes in the level of allowances.